Supreme Court of the United States

No. 814

PETITIONERS REPLY BRIEF

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960.

NO. 814.

REX SCHEPP AND BENJAMIN F. SHEPP,
Petitioners,

vs.

PRODUCERS, INC., TRAYLOR BROS., INC., INDUSTRIAL CONTRACTORS, INC., CARL WOLF, SMITH AND BUTTERFIELD, INC., RED SPOT PAINT AND VARNISH COMPANY, INC., DOUGLAS H. McDONALD, DOUGLAS H. McDONALD, TRUSTEE, AND EVANSVILLE TELEVISION, INC.,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

REPLY BRIEF FOR PETITIONERS.

I.

The assertion of respondent petitioning creditors (Brief p. 10) that Rex Schepp and Benjamin F. Shepp (petitioners here) consented to a finding of good faith, and an order appointing a trustee, before hearing on the controverting answer, is itself a manifestation of the lack of good faith

which has characterized the prosecution of this reorganization.

We suggest that examination of the record will disclose who has "misstated the facts."

On December 31, 1958, the day after filing his controverting answer, Rex Schepp (who is not a lawyer) appeared *pro se* at the hearing set on the petition and debtor's answer. B. F. Shepp did not appear and Mr. Barnett, his lawyer, was not there "on any official status," and obviously did not appear for him. The colloquy between Mr. Gesas (for petitioning creditors), the Court and Rex Schepp, at the conclusion of this hearing, was as follows:

> "Mr. Gesas: Your Honor, I might say to you I have talked to Mr. Barnett, who is not here on any official status. He advises me that Mr. Schepp is agreeable at this time that whatever order the Court proposes to enter, that it be entered in relation to the good faith and appointment of a Trustee, and with the understanding and the law provides without any understanding the understanding he has a right on his controverted answer to be heard within what period of time the Court can properly hear him. Is that correct, Mr. Schepp?
>
> Mr. Schepp: That is correct. * * *" (R. Ap. II, 15)

Did Rex Schepp intend by this to withdraw the controverting answer, to concede "good faith" and to consent that the corporate assets should be vested in a trustee? Did he agree that the recreant directors' unlawful consent should stand, and the debtor should be permanently disabled from defending against the conspiratorial attack which was alleged in the controverting answer? Or did counsel with the Court's approval seek to make a consent appear where none existed?

Consent that an order be entered "in relation to the good faith and the appointment of a trustee" certainly was

not consent that good faith should be confirmed and a trustee appointed. The order which Schepp had a right to expect "in relation to" these matters was an order continuing the status quo until the challenged good faith (and other challenged prerequisites) could be established *after* hearing the stockholders' answer, and *refusing* to appoint a trustee until that time.

II.

The positive *mala fides* evidenced by the false affidavits of Denis Stallings and Ferris Traylor is not "technical." It may be "semantic" in the sense that the intentionally equivocal and therefore false use of the word "paid" is exposable by "semantic" analysis.

Stallings' G. O. 5(2) affidavit was attached to the petition as evidence that Producers had not acquired the notes for the purpose of instituting the proceeding, and to show "the true consideration" for the transfer. Whether or not Stallings knew the difference between hearsay and personal knowledge, counsel who procured the affidavit undoubtedly did. Counsel requested Stallings to sign the affidavit, "based upon the information we were then giving you." (R. Ap. I, 36.) We can scarcely believe that learned counsel was wholly oblivious to the basic terminology of the law of evidence.

> "The first corollary from the general principle of Knowledge is that what the witness represents as his knowledge must be an impression derived from the *exercise of his own senses*, not from the reports of others,—in other words, must be founded on personal observation." II Wigmore Evidence, 3 Ed., Sec. 657, p. 762.

If the sufficiency of the affidavit did not depend on this positive affirmation of knowledge (respondents insist that

it did not) the offense is aggravated. What purpose in this falsity except its added effect in convincing the judge?

The assertion in both the Stallings affidavit (R. Ap. I, 11) and the Traylor affidavit (R. Ap. I, 31) that the transfer to Producers was made "in consideration of $300,000 being paid by Producers, Inc. to Traylor Bros., Inc." plainly is a wilful falsification of the *true* consideration.

It is quite true that "an obligation may be 'paid' or satisfied by a promise of payment or something other than cash". (Pet. Cred. brief, pp. 7-8.) In the Traylor to Producers to Traylor Bros. to Traylor (as outlined by Traylor) this happened. Producers' obligation to Traylor, arising from transfer of the notes, was paid by the book credit promise given Traylor Bros. Traylor Bros.' obligation to Producers arising from the book credit was *paid* by the book credit given Traylor. *But $300,000 was not paid to anyone.*

Respondents assert, in effect, that these falsifications are unimportant because, as they say, it is not a fact "that Producers, Inc. obtained its claim for the purpose of filing the reorganization petition." If this were sustained by the record it would be immaterial because wilfully falsified evidence to establish a material fact constitutes bad faith, although unnecessary.

Here circumstances conclusively indicate that Traylor did transfer the notes to Producers for the purpose of this proceeding. He first threatened receivership Nov. 12, 1958 (R. Ap. I, 59-60.) He transferred the notes to Producers Nov. 20, 1958. (R. Ap. I, 10.) At that time Traylor Bros., Industrial and Traylor himself were potential claimants. He says that he transferred the notes to Producers to "get the money to settle a personal income tax situation." (R. Ap. I, 40.) But what he got was not money but a book credit, not from Producers, but from *Traylor Bros.* (R

Ap. I, 40.) There is no evidence that he ever actually received $300,000 or any other sum to pay taxes. There is no explanation of why he did not transfer the notes directly to Traylor Bros. Even though *one* purpose may have been to obtain a $300,000 credit with Traylor Bros., the inference is irresistible that the purpose of the transfer to Producers was to keep the semblance of *three* creditors rather than two. If Traylor Bros., which (maybe) supplied the tax money, had become holder of the notes, then there would have been only *two* ostensible Traylor creditors.

Certainly it is not possible to demonstrate from the evidence the harmlessness of these false affidavits or the palpable lack of frankness and good faith in offering Traylor's unsupported and demonstrably false assertion of honest purpose.

III.

Whether or not it was for the best interests of the debtor to confess judgment in the reorganization proceeding, Traylor, Krueger, and Moser, who were personally interested in using the reorganization procedure to oust Schepp control, and only for that purpose, were not qualified to act for the corporation in making that decision. Consequently, their action in confessing the petition and representing that action as the product of lawful corporate action, thereby foreclosing a fair trial of the issue, exhibited the grossest lack of good faith.

Respondent petitioning creditors put forward the alleged "financial plight" of the debtor as complete justification for this fraudulent action. This, if true, would be no answer; but even in this attempt, respondents fail to disclose that the "balance sheet insolvency" cited on page 8 of their brief, was the result of a system of accounting installed by Traylor under which permit acquisition costs originally capitalized, had been charged to "expense," and

that the reversal of this bookkeeping would have shown a "balance sheet solvency." (R. Ap. I, 55, 56.) Even after the filing of the petition Traylor was both demanding and offering $10 per share for Equity Stock. While the stockholders' answers were still undetermined (July 1959) Traylor refused 100 cents on the dollar for his claims and $10 per share for his and other minority stock. (R. Ap. I. 102-120.) We doubt that directors not bent on achieving corporate control would have decided reorganization necessary.

Respondents suggest that "Petitioning Creditors certainly should not be chastened for attempting to save the debtor corporation from financial destruction by means other than a potentially costly reorganization proceeding." Obviously the only means "other than a potentially costly reorganization proceeding" which Traylor would countenance was to give him and his associates control and permit them to supply additional capital. Is it not possible that Schepp could have found someone else to do this if the usurping minority directors had relinquished their unlawful tenure? The debtor corporation and the Schepp minority were entitled to this. The use of the extraordinary equity powers conferred by Ch. X for the sole purpose of forcing the Schepps to sell out to Traylor is clearly unconscionable.

IV.

Without counting the intervenors, there were never as many as three qualified petitioning creditors.

(a) Producers, Industrial, and Traylor Bros. were, as "entities", subject to a single will, so that there was no concurrence of *three* separately motivated minds in the advisability of prosecuting a reorganization petition. *In re Watertown Paper Co.* (2nd C. C. A. 1909), 169 Fed. 252, does not decide that three claims under unitary control

constitute their corporate owners three creditors within the meaning of 11 U. S. C. 126. It holds that a parent corporation may claim against its wholly owned subsidiary in bankruptcy. Today it is doubtful authority for this proposition since *Taylor* v. *Standard Gas Co.* (1939), 306 U. S. 307. Under this case Traylor (with Producers, Industrial and Traylor Bros.) would have been subordinate to all other creditors of the debtor because of Traylor's control of the debtor under the expired voting trust. But the decision below permits Traylor by corporate schizogenesis (R. Ap. I, 38) not only to become *three* creditors, but to confess judgment on his own petition by virtue of his control of the debtor.

(b) Respondents, while professedly not admitting that the proceeding lacks three petitioners without counting intervenors, offer no argument to support the claim of Industrial as a separate "Entity". Even as a separate corporation, Industrial was a subcontractor under Traylor Bros. Traylor Bros. was the "entity" to whom was due the labor and material demand asserted by Industrial.

V.

Respondents' argument in support of the curative effect of the intervention of additional creditors is both unsubstantial and inconsistent.

(a) No attempt is made to apply 11 U. S. C. 95(f) which expressly authorizes the intervention of additional creditors to "join in the petition". Reliance is placed upon 11 U. S. C. 607 which contains no reference to intervention in support of the petition and therefore does not modify 11 U. S. C. 526 in the same manner that 11 U. S. C. 95(f) modifies 11 U. S. C. 59(b).

(b) Intervention in support of a petition in ordinary bankruptcy can obviously occur only prior to adjudication.

Under Chapter X, approval of a reorganization petition is equivalent to the adjudication in ordinary bankruptcy. The intervention which occurred in this proceeding occurred *after approval of the petition.* It was obviously not timely even though (which we deny) it would have been permissible prior to January 2, 1959. Consequently, respondents attempted distinction of *U. S. ex rel. Texas Portland Cement Company* v. *McCord* (1914), 233 U. S. 157, on the ground that in that case the intervention was not timely, does not distinguish. In this case, as in that, intervenors, who, at the time could have begun a new proceeding, attempted by intervention to give life to a proceeding which had never been lawfully begun.

(c) An intervention such as is attempted here, in support of a petition known to be defective for lack of three creditors and known to have been filed in bad faith, necessarily brands the intervening creditors with the same lack of good faith evidenced by the initial petition. The intervention in effect adopts the original petition and in addition to this it constitutes the institution of a reorganization proceeding against an alleged debtor already disabled from resistance by the wrongful approval of the original defective petition. Surely such an attempt to obtain advantage over a litigant incapable of litigating exhibits anything but good faith.

VI.

The appeals from the orders of allowance and from the injunctive order were both timely because both of these were interlocutory orders entered in the course of a proceeding in which a final order of approval was (insofar as the appellants were concerned) still *in fieri.*

Petitioners are not oblivious of the fact that had the orders of allowance been entered in the course of a reorganization proceeding in which the order of approval

had become final they would have been appealable only within the time allowed by 11 U. S. C. 650. They are also aware of the time limit of forty days specified by 11 U. S. C., Sec. 48 for appeals in bankruptcy. Respondents did take a timely appeal to the Court of Appeals from the final order which re-affirmed the initial approval of the reorganization proceeding. They submit that just as under 28 U. S. C. 1292, the permission to appeal an interlocutory order within thirty days does not foreclose review of such interlocutory order on a timely appeal from a final order taken much more than thirty days from the entry of the interlocutory order, so under the Bankruptcy Act intervening interlocutory orders are appealable with the appeal from a final order. We suggest that *Albin* v. *Cowing Pressure Relieving Joint Co., et al.* (1942), 317 U. S. 211, decides nothing to the contrary. It merely holds that an interlocutory order in bankruptcy is appealable as of right without leave. It suggests nothing as to why the same rule should not apply to interlocutory appeals in bankruptcy as applies to interlocutory orders appealable under 28 U. S. C. 1292.

Summary.

It is plain that the sole purpose of this reorganization proceeding was to obtain control of an allegedly insolvent but actually very valuable corporate property. (The price at which Traylor offered either to buy or sell and the price at which Traylor refused to sell shows clearly the sham in the claim of insolvency.) The three original petitioning creditors were in fact one, namely, Ferris Traylor. Ferris Traylor also controlled the debtor's Board of Directors who were associated with him in an attempt to oust the lawful majority control. By means of this minority control a judgment of approval was ostensibly confessed by the alleged debtor on a petition supported by affidavits knowingly